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## Nonprofit Corporate Governance: What Board Members Need to Know Legal Considerations

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Lorri A. Dunsmore  
Perkins Coie LLP  
1201 Third Avenue, Suite 4800  
Seattle, WA 98101-3099  
(206) 359-8528  
LDunsmore@perkinscoie.com

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## Questions to Ask

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- What does it mean to serve on a Board from a legal perspective?
- What are the key fiduciary duties of Board Members?
- How should conflicts of interest be addressed?
- How do I manage liability and minimize risks?

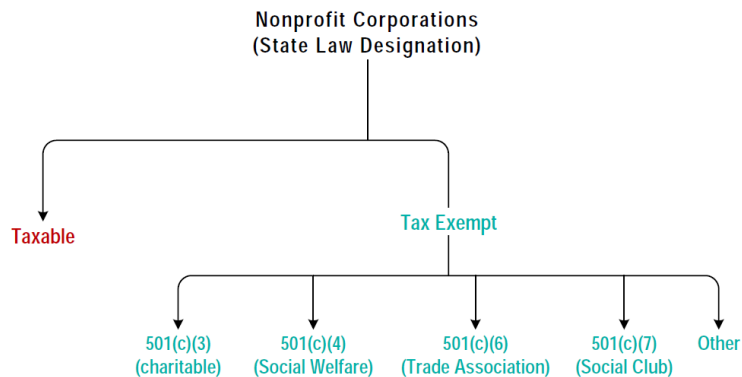


## Questions to Ask (contd.)

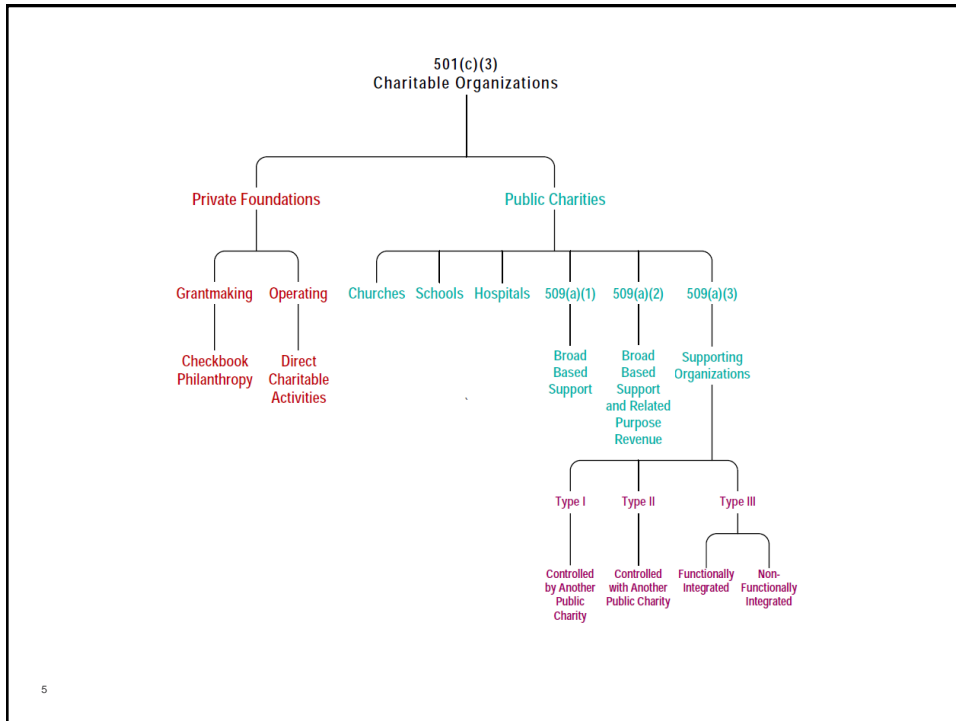
- What is expected of Board members?
- Is there D&O insurance?
- What do the organizational documents provide regarding director liability limitations and indemnification?
- How should a Board conduct a governance review?

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## Minimize Risks Through Understanding the Law – Duty of Obedience

- The duty of obedience requires a director of a nonprofit corporation to understand and carry out the mission of the nonprofit corporation in a lawful manner.
- The duty of obedience encompasses the duty of care and the duty of loyalty.

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## Minimize Risks Through Understanding the Law – Duty of Care

- The duty of care requires a director of a nonprofit corporation to act with such care, including reasonable inquiry, as an ordinarily prudent person would use in similar circumstances. RCW 24.03.127.
- To act with the proper care, a director should attend meetings, gather and review relevant information and use reasonable judgment in making decisions.

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## Minimize Risks Through Understanding the Law – Duty of Loyalty

- The duty of loyalty requires a director of a nonprofit corporation to serve in good faith and act in the best interests of the nonprofit corporation. RCW 24.03.127.
- A director of a nonprofit corporation should put the best interests of the nonprofit corporation above the director's own personal interests when making decisions for the nonprofit corporation.

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## Minimize Risks Through Understanding the Law – Duty of Loyalty (contd.)

- A director of a nonprofit corporation should be aware of potential conflicts and act openly and honestly in dealing with such conflicts.
- Disclosure and reasonableness are key factors.

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## SECRETARY OF STATE RESOURCES

- Charity and Nonprofit Board Service in Washington State Guidebook
- See [www.sos.wa.gov/charities](http://www.sos.wa.gov/charities)
- See [www.wayfindlegal.org](http://www.wayfindlegal.org)

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## Minimize Risks Through Understanding the Law – Private Inurement

- Fundamental concept that distinguishes charitable organizations from for-profit organizations.
- To avoid private inurement, no financial benefit can inure to a shareholder or private individual.

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## Minimize Risks Through Understanding the Law – Private Benefit

- To avoid private benefit, a charitable organization must operate exclusively for exempt purposes.
- Incidental private benefit is permissible.
- Broader rule than the rule against private inurement.

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## Minimize Risks Through Understanding the Law – Intermediate Sanctions

- Applies to public charities.
- An excise tax equal to 25% of the excess benefit applies to any person subject to the intermediate sanction rules who engages in an excess benefit transaction with a public charity.
- If the excess benefit transaction is not corrected within the taxable period, an additional excise tax equal to 200% of the excess benefit is imposed.

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## Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- An excise tax equal to 10% of the excess benefit is imposed on any organization manager that knowingly participated in the excess benefit transaction, provided that such participation was willful and not due to reasonable cause.
- The maximum penalty for managers is \$20,000 and is a joint and several obligation of the managers. The penalty does not apply to managers that voted against the transaction.

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## Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- An excess benefit transaction is a transaction in which the economic benefit provided by the charity exceeds the value of the consideration provided by the disqualified person. Whether there has been an excess benefit depends on all the facts and circumstances.

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## Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- Reasonable compensation is not an excess benefit and therefore does not trigger the intermediate sanctions penalties.
- An economic benefit received by a disqualified person is considered compensatory only if the public charity clearly indicates its intent to treat the benefit as compensatory.

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## Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- To protect both the charity's managers and the disqualified person from being subject to the intermediate sanctions penalties, the charity can create a rebuttable presumption that the compensation paid to the disqualified person is reasonable. In order to create this presumption, the following three conditions must be met.

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## Minimize Risks Through Understanding the Law – Intermediate Sanctions (cont.)

- The arrangement must have been approved by the governing body of the charity.
- The governing body must have obtained and relied on appropriate comparable information.
- The governing body must have adequately documented the basis for its determination concurrent with entering into the arrangement.

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## Minimize Risks Through Understanding the Law – Self-Dealing

- Applies to private foundations.
- An excise tax equal to 10% of the amount involved with respect to the self-dealing transaction on any person subject to the self-dealing rules who engages in an act of self-dealing with a private foundation as well as an excise tax equal to 5% of the amount involved with respect to the self-dealing transaction on any foundation manager who participates in such transaction.

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## Minimize Risks Through Understanding the Law – Self-Dealing (contd.)

- The self-dealing excise tax may be increased to 200% if the self-dealing act is not corrected within the taxable period.
- The manager's excise tax may be increased to 50% if the manager refuses to agree to part or all of the correction, with a maximum aggregate tax on managers of \$40,000 with respect to one act of self-dealing.

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## Minimize Liability – Identify and Address Conflicts of Interest

- State law obligations.
- Duty of loyalty.
- Duty of care.
- Exception on limiting personal liability of directors; cannot limit liability of a director for any transaction from which the director will personally receive a benefit in money, property or services to which the director is not legally entitled. RCW 24.03.025(4)(c).

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## Minimize Liability – Identify and Address Conflicts of Interest (cont.)

- Prohibition on private inurement.
- Representations on tax-exempt application. (Form 1023)
- Representations on annual information return. (Form 990 or Form 990-PF)
- Intermediate sanction/excess benefit rules for public charities. (IRC Section 4958)

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## Minimize Liability – Identify and Address Conflicts of Interest (cont.)

- Self-dealing rules for private foundations. (IRC Section 4941)
- Sarbanes-Oxley Act.
- Increased actions by attorneys general around the country.
- Compliance with various good governance guidelines.

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## Minimize Liability – Identify and Address Conflicts of Interest (cont.)

- Desire to avoid negative publicity.
- Desire to be transparent and open to various constituencies.

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## What is a Conflict of Interest?

- A conflict of interest exists when a director has a material personal interest in a proposed transaction to which the nonprofit corporation may be a party.
- A conflict of interest is not inherently illegal or unethical.
- "*No Conflict/No Interest*" John Doerr
- A conflict of interest does not automatically mean the conflict is detrimental to the nonprofit corporation.

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## Examples of Conflicts of Interest

- A business owned by a director sells computer equipment to the nonprofit corporation.
- An insurance agent who is also a director sells insurance to the nonprofit corporation.
- The nonprofit corporation pays the president compensation for the president's services to the nonprofit corporation.

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## Examples of Conflicts of Interest (cont.)

- Information obtained from the nonprofit corporation allows a director to make decisions on the sale or retention of personal assets.
- The nonprofit corporation loans funds to an officer, director or other key player.

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## How should a Conflict of Interest be addressed?

- Overall goal should be to clearly document that the potential conflict of interest was disclosed, and the board made its decision based on the fairness of the transaction and the best interests of the nonprofit corporation.

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## How should a Conflicts of Interest be addressed? (cont.)

### Preemptive steps:

- Adopt a conflict of interest policy.
- Review the policy annually with relevant parties.
- Require periodic certification from relevant parties indicating they have read and understood the policy and that they have and will comply with the policy.

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## Anatomy of a Conflict of Interest Policy

### Overall objective of the policy

- To protect the interests of the nonprofit corporation when it is contemplating entering into a transaction that might benefit the private interests of a key player.

### Who should be covered by the policy?

- Directors, officers and key players.

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## Anatomy of a Conflict of Interest Policy (cont.)

### What are the procedures when there is a potential conflict?

- Duty to disclose all actual or possible material direct or indirect conflicts and relevant facts.
- Duty to respond to allegations of wrongdoing or conflicts after the fact.

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## Anatomy of a Conflict of Interest Policy (cont.)

### What are the procedures when there is a potential conflict?

- The interested party should fully disclose such information and then leave the meeting.
- The disinterested directors should fully discuss the information.

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## Anatomy of a Conflict of Interest Policy (cont.)

- A decision should not be made until the directors know the full scope of the potential conflict and have made a reasonable investigation to determine whether the nonprofit corporation can enter into a better or more advantageous transaction with a different party.

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## Anatomy of a Conflict of Interest Policy (cont.)

### Minutes should contain:

- A reasonably detailed description of the potential conflict.
- The additional facts considered.
- Documentation of the absence of the interested party from the discussion and vote.
- A list of all directors who voted for and against the proposed transaction.

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## Minimize Liability Risk Through Law and Organizational Documents

- RCW 4.24.670 provides volunteers of certain nonprofit organizations with some liability protection.
- Volunteer must meet certain conditions to qualify for protection.
- Volunteer means a person who does not receive compensation. Reasonable reimbursements are allowed.

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## Minimize Liability Risk Through Law and Organizational Documents (cont.)

- Director liability limitations under nonprofit statute.
- Director and officer indemnification under statute.

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## Manage Liability Risk Through D & O Insurance

- Coverage
- Exclusions
- Costs
- Availability

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## Minimize Liability Risk Through Actions

- Understand role.
- Attend meetings.
- Review and approve minutes.
- Understand financials.
- Understand rules.
- Know when to seek advice.

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## Other Tips for Minimizing Risks/ Managing Liabilities

- Carefully select new Board members.
- Train Board members.
- Carry personal umbrella insurance.

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## How to Conduct a Governance Review

- Appoint a committee.
- Decide on the objective of the review.
- Gather information.
- Seek input from relevant stakeholders.

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## How to Conduct a Governance Review (cont.)

- Develop recommendations.
- Report to the full Board.
- Implement approved decisions.
- Expect the process to take time.

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## Governance Review – Legal Framework

- Review key organizational documents.
- Determine whether the operational rules in the organizational documents correlate with how the organization actually operates.
- Have there been law changes?

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## Governance Review – Board

- Do you have active, independent, informed Board members?
- Do you have the right Board composition?
- Do Board members understand their duties?
- Are your Board members vested in your mission?

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## Governance Review – Committees

- Do you have committees?
- How are they structured?
- Do they have Board authority?
- Do they have separate charters?
- RCW 24.03.115

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## Governance Review – Staff

- Do you have the right staff right now?
- Do you understand the roles of key staff members?
- Do your key staff members understand their roles?
- Chain of command?

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## Policies and Procedures

- What policies do you have?
- What policies do you need?
- What policies are required?
- Are you complying with your policies?

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## AG's Office Investigating Illegal Loans

- Foundation reviews investment strategies and concludes loans may result in better return.
- Foundation loans funds to its President to purchase a house. Loan is secured by the house.
- Foundation loans affiliated for-profit company funds to keep company afloat. Interest is prime plus 3% and fully secured.

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## First-Class Perks

- Bob and Bertha Brown are the founders, funders and directors of Brown Family Foundation.
- The Browns are considering making a \$10,000 donation to a museum in Hawaii.
- Prior to funding, the Browns fly first class to Hawaii and spend a week performing due diligence on the Aloha Museum.

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## Board Members Open Wallets

- Shelter is facing closure in the middle of winter.
- Shelter elects to keep doors open until spring by using tax withholdings from employees to pay bills.
- Shelter treats part-time counselors as independent contractors.

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## Bad Investments Result in Loss of Funds – Board Faces Intense Scrutiny

- The Famous Family Foundation invested most of its assets in Madoff-related investments.
- The Famous Family Foundation lost almost all of its assets in Madoff's Ponzi scheme.
- The IRS and AG's office are investigating.

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## Donor Outrage Sparks Investigation

- Market plunges and Tough Times Charity makes a decision to dip into endowment funds to meet current expenses. Donor blows whistle.
- Market plunges and Sheltered From the Storm Charity seeks donor approval to modify terms of endowments.

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## Employee Blows Whistle Board Lands in the Penalty Box

- Mr. Debonair is the new development officer for All Is Good Charity.
- The Board was pleased when Mr. Debonair accepted the job.
- Ms. Ima Tattler informs the Executive Director, Board and then the press about Mr. Debonair's wandering hands and bad judgment.

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## TREASURER GAMBLES CHARITY LOSES

- Lincoln Springs Youth Soccer Association annual fundraising effort nets \$30,000 for new fields.
- Mr. E.Z. Money tries his hand at blackjack at the Four Elements Casino.
- Mr. Money should not change his name to Mr. Lucky.
- Unfortunately, by the time Mr. Money realizes he isn't any good at blackjack, the LSYSA's bank account is reduced to zero.

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